Who pulled the strings?

Heij, G.

Publication date:
2007

actors such as domestic ministries of finance, Asian Development Bank, IMF and the World Bank.

The fieldwork included interviewing key decision-makers and key advisers in the tax reforms in both countries. Where possible, the names and nature of the interviews are mentioned in footnotes on the relevant pages throughout this study. Fieldwork in Indonesia was mainly conducted in the period 1993–98 and in Vietnam 1995–98. Country specialists were also interviewed to put the reforms into perspective. Interviews were conducted with historians, political scientists, anthropologists, economists and lawyers who have particular expertise in Vietnam or Indonesia.

Obtaining information on the reform in Indonesia proved to be much easier than in Vietnam. As is explained in the Vietnam chapter, difficult access to information is a challenge faced by many researchers and relates to the unique features of the Vietnamese socialist government structure.

2. THE DEFINITION OF TAX[5]

2.1 INTRODUCTION

Many contemporary social, economic and political studies in the area of taxation do not give any attention to the definition of the term 'tax'. Apparently it is assumed that everybody understands what the word 'tax' means.[6] It is important to distinguish between tax and taxation. Taxation refers to the act or practice of imposing taxes or the fact of being taxed. Taxation can also refer to the revenue gained from taxes. For our research we focus on the definition of 'tax' rather than taxation. This chapter discusses various definitions of 'tax' and their often overlooked shortcomings. Such discussion is crucial to our analysis of the case studies of tax reform in chapters 5 and 6. As these case studies will demonstrate it is impossible to explain the reforms with the help of the generally used definition of tax.

Comparisons between different tax systems in different countries also require a workable definition of the term 'tax' and other terms related to this such as tax burden and tax ratio. Statistical analysis and international tax comparisons are made almost impossible due to the different classification of tax versus non-tax revenue (as touched on by Bird (Bird 1991). Nevertheless, statistics on tax burden, distribution of tax burden, and tax revenue, that make use of very limited definitions, are often used as a foundation for advice on tax measures in developing countries. One only has to

5 This chapter has been published in slightly different form in Heij, G. (2001). "Definition of tax in the Asian context." Asia-Pacific Tax Bulletin **7**(4). The 1911 edition of the *Encyclopaedia Britannica* defines taxation as "That part of the revenue of a state which is obtained by compulsory dues and charges upon its subjects".

6 For example, Steinmo, S. (1993). Taxation and Democracy; Swedish, British, and American Approaches to Financing the Modern State. New Haven and London, Yale University Press. Campbell, J. L. (1993). "The state and fiscal sociology." Annual Review of Sociology **19**: 163-185, Campbell, J. L. (1996). "An institutional analysis of fiscal reform in post communist Europe." Theory and Society **25**: 45-84.and Urrutia, M., S. Ichimura, et al., Eds. (1989). The Political Economy of Fiscal Policy. Tokyo, The United Nations University.

look at the many tax policy papers issued by the World Bank and the Asian Development Bank to see how such statistics are used to form the basis of policy advice (World Bank 1992).

2.2 VARIOUS DEFINITIONS OF TAX

The term ‘tax’ refers, according to the Organisation for Economic Co-operation and Development (OECD), to

> … a compulsory unrequited payment to the government. Tax may be assessed on a person, entity, assets etc. Tax may be levied in the form of an income tax, gift tax, estate tax, excise tax, inheritance tax, value-added tax, sales tax, capital gains tax, property tax etc.(International Bureau of Fiscal Documentation 1996, p.292).

‘Requited’ payments are payments which are reciprocated or returned and do not qualify as a tax because there is a clear and direct benefit in exchange for the contributions made. The OECD definition excludes, for example, charges and levies because they are not unrequited (although it could be argued that the word ‘unrequited’ is rather ambiguous). The OECD definition does not explicitly include payments made in kind nor disguised taxes that do not fall under the forms mentioned in the definition.

The *Oxford English Dictionary* (Onions 1992) defines a tax as

> *…*a compulsory contribution to the support of government levied on persons, property, income, commodities, transactions etc, at a fixed rate mostly proportionate to the amount on which the contribution is levied.

The element ‘compulsory’ is common to both definitions. ‘To the support of government’, is vaguer than ‘to the state/government’. The OECD definition does not mention anything about the unrequited character of a payment and it puts particular emphasis on the proportionate character of tax.

According to the economist Tiley (Tiley 1978, p.3), taxes have the following elements:

> They are compulsory, they are imposed under the authority of the legislature, they are levied by a public body and they are intended for public purposes.

According to the Penguin *Dictionary of Economics* (Bannock, Baxter et al. 1972, p.395) a tax is

> ...a compulsory transfer of money (or occasionally of goods and services) from private individuals, institutions or groups to the government. It may be levied upon wealth or income or in the form of a surcharge on prices.

In summary the following elements recur in most legal definitions of tax. Tax is

- compulsory
- a contribution in monetary or other form
- by individuals, organisations or other entities
- received by the government
- for public purposes
- ‘unrequited’

Such a definition may be useful for legal purposes and can be helpful for the various tasks of public administration. For example, it may assist in establishing which court (administrative, civil or tax) is authorised to deal with particular financial disputes or which government body is authorised to collect a certain level of payments. Thus, for example, in the case of particular levies, local councils or private institutions may be authorised to collect payments, whereas in the case of a ‘tax’ the central government may be the only authority.[7]

There are many different definitions from a technical fiscal perspective. Significant contributions have been made by tax lawyers, accountants and fiscal economists discussing and defining the term, sometimes arguing over subtle differences. According to fiscal economist Steven, it is impossible to give a general definition of tax. He points out that there are so many differences that it is crucial to examine each tax law, tax treaty or other arrangement for its individual approach to the term tax. (Steven 1998, p.7). This is illustrated by the long and painful tax harmonisation process in the European Union. One of the main problems is the wide range of definitions of tax, taxable income and tax base used by its member countries (Tax Analysts 2000).

Within the economic sciences the legal approach to the definition of tax gives rise to various problems. Economists are, as social scientists, interested in the actual tax burden and/or actual government revenue. The legal definition does not solve this problem. For example, are social security contributions a tax or not? Are royalties a tax or not? In both cases the payments contribute to state revenue are often collected at the same time and with the same collection procedure as income tax, and are perceived as a tax by the people who pay, but according to the legal definition they are not included as a tax. Many economists use the legal definition as a convenient way to compile data that can easily be quantified. This information results in statistics used for comparative research on a national and international level and the collected data feeds easily into economic models.[8] But the information may be far from complete as the real tax burden or level of revenue may differ from the data collected.

For tax advisers, the legal definition may not suffice to fully inform their clients about their real financial burden. For example, the tax rates of Singapore or Hong Kong

7 Politicians use this legal definition to their advantage. For example, they may decrease the taxes levied under the legal definition and increase other government levies and direct fees. Based on the legal definition, the official tax burden declines, which is often warmly welcomed by the electorate, even though the actual financial burden increases.

8 When I pointed out to a senior economist that the existing legal definition does not give a true picture of the actual tax burden and tax revenue in Indonesia, he replied, “That may be true, but any other definition does not fit into my economic models and statistics”. This economist played an important role in the Indonesian tax reform process in the 1980s.

may look relatively low but the real financial burden can be much higher as governments obtain a large part of their revenue via the leasing of government-owned land. Taxpayers in Indonesia or Vietnam may experience significant additional payments in the form of facilitation fees paid to tax officials in addition to the legal taxes payable.

More problems occur when the legal definition is used for research in the area of sociology, as it arbitrarily limits empirical research. There are payments that do not constitute a tax under the legal definition but could be seen as such by sociologists. Nevertheless, the social sciences have largely neglected the problem, with many social science reference works, such as sociology encyclopaedias, omitting the term 'tax' altogether.[9]

Let us examine in more detail the shortcomings of the generally used legal definition of tax.

Tax payments must be compulsory

All definitions of tax implicitly or explicitly presume the compulsory character of payment. In most cases this will not be problematic, as not many people would voluntarily pay taxes. However, problems do occur if a tax is not compulsory in a legal sense, but non-payment would lead to social, economic or other pressures. In other words, social control and pressures can force people to pay taxes that in a strict juridical sense may not be classified as such.

An interesting example is the so-called 'poverty tax' introduced in Indonesia in 1996. Under a decree that became effective on 4 December 1996, a 2% surcharge was levied on the after-tax profits and incomes exceeding IDR 100 million of both companies and individuals. The revenue from the surcharge was officially earmarked for helping the poor. The payments were made to charitable foundations controlled by former President Suharto. The Indonesian tax department was appointed as collector of the payments. The levy was a political gesture from the Indonesian Government to curb increasing criticism that the gap between the rich and poor in Indonesia was widening. Payment was initially voluntary, but was later made compulsory. However, that was not done by law but only by decree, which is not the official procedure for the introduction of new taxes.

During the period this charge was levied (1996–98) various approaches were applied regarding the levy. Those foreign businesses active in Indonesia (and therefore subject to paying taxes) that were not involved in Indonesian government work were generally advised by their tax advisers not to pay. They could defend themselves by saying that paying might cause problems in their home countries[10]. Those foreigners involved in government work did pay the 2%. Although legally they perhaps were not obliged to do so, economic pressure insured that they would pay as long as they

---

9 Elliot, F. and M. Summerskill (1957). A Dictionary of Politics. Great Britain, Penguin Books, Theodorson, G. A. and A. G. Theodorson (1969). A Modern Dictionary of Sociology. United States, Harpers & Row, Rademaker, L., Ed. (1978). Sociologische encyclopedie. The Netherlands, Het Spectrum, Marshall, G., Ed. (1994). Oxford Concise Dictionary of Sociology. Oxford, Oxford University Press.

10 For example, according to various rulings under American law the payments can be seen as illegal payments.

wanted to obtain government contracts. Indonesian taxpayers generally did pay because they felt obliged to do so, since the president initiated the levy and chaired the foundation. Non-payment could be seen as a direct protest against the president, with unpredictable consequences.

Those paying the 2% would all agree that it was a tax, even though they would concede the weak legal basis. In short, the term 'compulsory' is not always sufficient as it does not cover the prevailing social and economic pressures under which payment takes place. Moreover, the example illustrates that the condition that the state should be the receiver of the payments is not always met. It is interesting to note that none of the available revenue statistics on Indonesia include any of the payments made to Suharto's foundations. Neither the statistics of OECD, IMF or World Bank nor the statistics provided by the Indonesian Ministry of Finance give any information about this flow of revenue.

Payment in money or another form

Historically, much of the revenue of political rulers has been in *natura* (Grapperhaus 1989). Many countries use conscripted labour for military and other purposes. One could argue that this constitutes a tax, namely the difference between the remuneration of the conscripts and that necessary to attract the same number of people on a voluntary basis. (Prest 1972, p.147) In the Indonesian situation, community service (*gotong rojong*) is an important element of income in *natura* at the local village level. The service finds its roots in the *adat*[11] laws of Indonesia and goes back many centuries. The service is in some ways recognised by the central government as a form of taxation. On the island of Bali, for example, the service has been seen as a substitute for paying land and building tax (PPB). This view only started to change in the second part of 1997, when Indonesia faced serious economic problems and a major decline in government tax revenue.

A similar service, *corvee*, applied in pre-revolutionary France when labour had to be supplied to the state without pay for certain purposes. Although *corvee* was formally abolished after the end of French rule it is still widely performed in rural Vietnam. In November 1997, the Vietnamese Government proposed the formal reintroduction of working one day a week or month for the public good, which was accepted.

No statistics on tax revenue include the value of such mandatory services, nor are they included in the assessment of the actual tax burden in a particular country.

Generally taxes are paid by both individuals and various social and economic organisations. But sometimes such payments must be made that are not labelled as taxes but are hard to distinguish from tax. This problem is not new. The 1911 edition of the *Encyclopaedia Britannica* (p.325) pointed out that the state may have other sources of income, for example, from state properties. The entry draws attention to the problems that exist in distinguishing between those two sorts of income. For example, as mentioned earlier, the tax rates of Singapore or Hong Kong may be relatively low but the real financial burden can be much higher as governments obtain a large part of their revenue via the leasing of government land.

[11] *Adat* law is the customary law of Indonesia.

As well, certain groups may in fact contribute much less to government revenues than initially thought. In the case of countries with strong government control of the economy, such as Vietnam, Indonesia, India, Malaysia, Singapore and the People's Republic of China, state support for state-owned enterprises (SOEs) forms a real problem in assessing the tax burden for these enterprises. Such support can take the form of certain pricing policies towards SOEs, for example, allowing them to acquire human, financial, land and other resources at below market value.

Taxes have to be paid to the government

According to Prest (1985) it is possible to levy a tax without there being any flow of funds to the government. He suggests, for example, that tariffs and/or import controls intended to protect local producers, which force domestic consumers to pay higher than international market prices, can be seen as implicit taxes. Another example is when producers or consumers have to adjust their behaviour in order to conform to environmental standards. The control of housing rents below or above market levels can be seen as another example, whereby the landlords are either taxed or subsidised. This sort of implied tax is never included in fiscal statistics.

Taxes are for public services

Taxes are collected to fund public services. What the term 'public services' means can be quite controversial. What is viewed by some as a public service may be seen as payment to individuals by others. For example, in the Philippines the family of former president Marcos used tax money for personal purposes and few would argue that a public service was provided in this way. Nevertheless, nobody would challenge the tax character of the revenues collected that were subsequently used for the Marcos family, and fiscal statistics took no account of such private use.

Further problems may occur with fines. The main purpose of a fine is allegedly to correct certain behaviour while the main purpose of a tax is supposedly to generate revenue for public services. Most agree that penalty payments to prevent delayed compliance are not part of a tax but more in the nature of late filing charges or interest charges which fall under tax compliance costs. But tax codes are full of provisions intended to encourage or discourage behaviour. Take, for example, the fact that many governments intend to discourage smokers by levying high levels of sales tax on tobacco products. The excise taxes on alcohol are included in all statistics as tax revenue, while the main purpose of some of them (for example, in Scandinavia) is to correct certain behaviour.[12] In short, there is a grey area between fines and taxes.

In Indonesia, penalties outlined in the Indonesian tax laws are used as an additional source of revenue for the tax department. They are sometimes levied at random and in some cases without cause, or at least with only a disputable reason. Only when the sums are large are taxpayers tempted to appeal to the tax appeal board, a time-

---

12 Tiley argues that the important difference between the two is that the court has the power to vary the fines and to imprison for continued breach, and this marks off the breach of the criminal law from carrying on a taxable activity. This is a weak distinction, since taxes are in part often subject to negotiation and penalties (e.g. for many traffic offences) are in practice fixed (Tiley, J. (1978). Revenue Law. London, Butterworths.).

consuming and costly exercise.[13] If the penalties are used as an unofficial source of revenue for tax officials, they are of course not included in the revenue statistics, although a very real part of the 'tax burden'.

Another grey area is the payment of facilitation fees to civil servants, a phenomenon of considerable importance in many countries. The payments can relate to settling a final tax assessment, to obtaining certain services or goodwill from the local, provincial or central government, or simply avoiding harassment from government officials. The economists Booth and McCawley pointed this out in 1981 (Booth and McCawley 1981, p.137) in regard to the Indonesian situation:

> The many unofficial levies imposed by military and civilian personnel on a wide variety of business and personal transactions are of considerable importance in discussions about the overall tax burden in Indonesia. While these levies have long been a well-known feature of Indonesian life in spite of various official campaigns to eliminate them, they tend to be overlooked in discussions about revenue policy. But in parts of the outer islands, these levies are almost certainly of more importance than conventional tax collections. In addition, they give rise to considerable popular resentment because of their arbitrary nature and the inconvenience they cause.

On a local level many taxpayers do not make a distinction between official and unofficial payments made to representatives of the public service. The additional levies are often significant for those at the village level. When we use the OECD definition it may seem that the actual tax burden at the local level is quite low. However, if we apply a broader definition, the outcome may be quite the opposite.

In the case of Vietnam, economists like Beresford warned that the situation would lead to severe problems. Unfortunately, Beresford's concerns have been proven correct and, in 1997, riots broke out in northern Vietnam. Local villagers were increasingly angry with the government for demanding higher contributions, some based on the laws and some not (Beresford 1997). Many of these contributions are not reflected in government tax revenue statistics.

Taxes are unrequited

Following the OECD definition, social security contributions are included in total tax revenue. Thus, countries with no, or a limited, social security system, for example, Hong Kong, appear to have a lower percentage of total tax revenue (as a percentage of GDP) than those countries with an extensive social security system, such as the Netherlands and Sweden. But one could argue that social security payments are in effect compulsory insurance payments, so there is a clear benefit in exchange for the contributions made, even though the payments are made to the government. From this point of view, they should not be considered a tax. On the other hand, others argue that because of the lack of a direct connection, such payments should be seen as a tax (Tiley 1978). The recent trend in many European countries to privatise

[13] To the surprise of many, most cases before the appeal board were decided in favour of the appealing taxpayer (at least in the period 1984–97). Unfortunately, the then president forbade making the appeal board's decisions public. According to well-informed tax advisers in Jakarta, the court decides around 80% of tax appeal cases in favour of the taxpayer.

pension funds, sickness benefits and health insurance funds creates new problems. Do payments to private funds fall under the definition or not?

Royalties on minerals are not included in the OECD definition because they are seen as payments in exchange for the exploitation of particular minerals. Thus, such payments are not unrequited. However, in some countries there are particular tax regimes for mining companies, which may result in increased tax revenue. In other countries rich in minerals, mining companies may enjoy considerable tax incentives that are compensated for by higher royalty levels on minerals. This results in misleading statistical comparisons of the real tax burden in different countries.

The issue of taxes versus charges for government property or services is a continuing source of confusion. Recent court cases in Europe show that there are no simple answers. The tax harmonisation process in the European Union has resulted in court cases about whether certain charges should be classified as turnover taxes (Tax Analysts 2000). One could argue that a government charge directly related to the provision of a service cannot be classified as a tax. But it is not uncommon that there is an excess profit included in the fee, for example, in the case of patent fees. In that case the excess profit could be viewed as a tax.[14]

In Hong Kong there has been a long tradition of using land revenue for government purposes. Via a system of leasing Crown land Hong Kong has been able to keep tax rates low; however, the costs of leasing land and property are astronomical.[15]

Problems with comparing tax revenue as percentage of GDP

One of those who has recognised the dilemmas of the concept of a tax is the economist Sandford (1989).

He acknowledges that the common method defining the overall tax burden[16] — total tax revenue as a percentage of community output (GDP) — has its shortcomings. This percentage may not cover all actual taxes as demonstrated above. Moreover, as he points out, there are significant problems when we compare the overall level of taxation as opposed to the division of the separate taxes within the overall tax revenue in various countries. The overall level of taxation says very little about the breakdown of various taxes, possible tax incentives, rebates, rates etc. Sandford knows the approach is not perfect but sees it as the best option in order to provide a rough indication of the overall level of taxation. The problems with defining the term 'tax' also occur with the definition of 'GDP' (broad versus narrow, what to include in

14 The Canadian courts have been forced to clarify this matter in various court cases (Tiley, J. (1978). Revenue Law. London, Butterworths.). They ruled that the payment is a charge rather than a tax for government services: 1. If the services are provided directly to the individual. 2. If it relates to the service given and does not depend upon the payer's ability to pay or depend on the value of, for example, the payer's property. 3. The charge may result in a profit as long as it is a reasonable one. It remains unclear how the word 'reasonable' is interpreted. If this ruling applied in other countries it could mean that services where payment depends on a payer's income, for example, would be classified as tax.

15 In 2000, it was estimated that property-related income accounted for one third of total government revenue in Hong Kong. If land sales were included, more than half of government revenue would come from property (Lingle (2000). "Step Back, Mr Tsang." Far Eastern Economic Review **163**(10): 33.).

16 According to the *International Tax Glossary*: "For public finance purposes the tax burden, or tax ratio, in a country is computed by taking the total tax payments for a particular fiscal year as a fraction or percentage of Gross National Product or national income of that year" (International Bureau of Fiscal Documentation (1996). International Tax Glossary, International Bureau of Fiscal Documentation.).

GDP and what not to include), which means that comparing tax ratios is even less reliable.

2.3 THE PROBLEM OF 'IMPLICIT' TAXES

One of the few social scientists who has attempted to formulate an alternative definition of tax is Prest (1985). Based on his research in the UK, he makes a distinction between explicit and implicit taxes (Prest 1985, p.11):

> By analogy with an explicit tax, an implicit tax must have the general economic characteristics of compulsory deprivation (of private sector purchasing power); but without there being any flow of funds from the private to the public coffers. With an implicit tax, Group A may find its purchasing power reduced whilst Group B's increases; but such a transfer takes place by means other than through the government's formal tax-collection and expenditure-disbursement machinery (though due in some fairly direct way to government action).

He thus mainly follows the legal definition outlined above, but the difference is that there is no budgetary evidence of the transaction. As Bird (1991, p.3) points out, Prest's definition means that no legislature need pass a tax act; no tax collector calls at your house; no taxpayer has any occasion to complain about the inequitable and inefficient nature of the tax system to which he or she is subjected; indeed, most would not even know they had been taxed. But due to the implicit tax, one is poorer and probably someone else is richer due to government action. In the UK, Prest identified various types of implicit taxes: tariffs and import controls, the pricing policies of public enterprises, rent and other price controls, land-use controls, and minimum wage laws. He argues that implicit taxes actually perform the tasks of explicit taxes but that it is very hard to put any figures on them. Mohammed and Whalley (Mohammed and Walley 1984) estimate that perhaps up to 45% of the GNP of India is produced by distortionary government policies (for example, artificial price settings, protection of state-owned enterprises, and government monopolies).

However, the work of Prest, McLure, Mohammed and Whally only covers a part of the limitations of the legal definition. There are no published studies available that deal with all the aspects of implicit taxes in a comprehensive way. Rabushka and Bartlett (Bird 1991, p.7) conclude that:

> There are a whole range of governmental actions which can be categorised as implicit taxes, in that they increase the prices of goods, the cost of doing business, or lower the rate of return. While it is extremely difficult to calculate the precise level of such 'taxes', they impact on incentives in the same way that explicit taxes do. Since such implicit [taxes] may be of significantly more importance than explicit taxes in determining a developing country's growth prospects, further research in this area should be a high priority, in order to quantify and categorise such 'taxes' and hopefully lead to their reform.

Based on these findings, the Sequola Institute attempted to fill in the gaps with collaborative research — titled 'More Taxing Than Taxes?' — by various economists on the issue of implicit taxes (Bird 1991). But the study still does not cover some of the shortcomings of the legal definition. Although it addresses problems of state-owned enterprises etc, it does not deal with unofficial levies by tax officials or other government employees, nor with payments in labour or kind, nor with the often-overlooked problems with the term 'compulsory'.

2.4 CONCLUSION

Realistically, it seems impossible to develop a workable definition of the term 'tax' that covers all the different possible uses of the term and does justice to concerns about the 'real' tax burden and so forth. However, it is important to be aware of what one is leaving out: whatever tax definition is selected, it will only cover a small part of a large and complex area, and it is inevitable that a significant part will be excluded.

For the social sciences a broader definition is needed if research is to give a more truthful picture of the reality of tax in society. However, doing so leads to a range of practical problems. Most statistics on tax revenue and the breakdown of the different taxes collected do not include any of the factors included in a broader definition. It would be very difficult to quantify the tax burden under a broader definition. But the fact that there are many 'taxes' not included in a narrow definition of tax definitely needs to be taken into consideration.

This study will use the OECD definition of tax for practical reasons (in particular, the availability of data). However, where relevant, detailed attention will be paid to a broader conception of tax, particularly when discussing the case studies.